



Economic Update

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Tax Cuts in Place to Boost Economy

Initial data in the post-Iraq period still remain too limited to assume a sustained economic rebound. The few signs available are encouraging, except that unemployment remains stubbornly high – and may continue that way for some time.

In this environment, Congress and the President have enacted a jobs- and growth-oriented tax relief package that appears to be especially well timed. Even Federal Reserve Chairman Greenspan – previously a skeptic about the need for fiscal stimulus – acknowledged last week that these measures were “happening at the right time.”

Incoming Data Are Encouraging

Though limited, initial data suggest the economy improved in the post-Iraq period. The pickup was somewhat muted, however, and it is also too early to tell whether the initial improvement indicates a sustained rebound. Following up on indicators cited in last month's *Economic Update*:

- *The stock market*: By early May, the S&P500 index had gained 15 percent from its pre-Iraq lows, and recently had advanced nearly 7 percent more after the tax cuts passed Congress. The Dow Jones Industrial average pushed above 9000 for the first time since last summer – after falling below 7600 as recently as early March.
- *Consumer confidence*: Consumer confidence rose to 83.8 in May, up from 62.5 in March at the height of the uncertainty about the Iraq conflict.
- *Retail sales*: Weekly chain store sales were at elevated levels in May and early June relative to late March and early April. Advance data show retail and food sales rose 0.1 percent in May; excluding gasoline, retail sales rose 0.3 percent.
- *Manufacturing and nonmanufacturing survey data*: The Institute for Supply Management's Purchasing Managers Index [PMI] data indicate

that both the manufacturing and nonmanufacturing sectors improved after the Iraq conflict, although the figures suggested manufacturing was flat and not growing. The nonmanufacturing PMI reached 54.5 in June, indicating fairly solid growth in those sectors (a reading above 50 indicates expansion).

Such data are encouraging, but continued increases in a multitude of indicators, over a reliable period of time, will be needed to reflect a return to sustained expansion. The likelihood of lasting gains in confidence and spending measures is bolstered by the expected forthcoming beneficial effects of the recently enacted jobs and growth tax relief legislation (see further discussion below).

Blue Chip Forecast Shows Improving Economy

Private forecasters remain optimistic. Reflecting in part the timing of the coming tax relief, the Blue Chip consensus forecast projects an improving economy as early as the third quarter of this year: real gross domestic product [GDP] growth is projected at a 3½-percent to 3¾-percent annual rate over the second half of 2003 and during all of 2004 (see table below). The Blue Chip forecast shows the unemployment rate declining after the third quarter, falling from 6.1 percent down to 5.6 percent by the fourth quarter of 2004. With the improving economy and the associated stronger demand, the Blue Chip forecast shows somewhat higher inflation and interest rates through the end of 2004.

Blue Chip Economic Outlook, June 2003

	2003.1	2003.2	2003.3	2003.4	2004.1	2004.2	2004.3	2004.4
	History	Projection						
Real GDP Growth	1.9	2.0	3.5	3.7	3.8	3.6	3.6	3.5
Unemployment Rate	5.8	6.0	6.1	6.0	5.9	5.8	5.7	5.6
CPI Inflation	3.8	1.1	1.5	1.8	2.0	2.1	2.2	2.2
3-month Treasury Bill	1.2	1.1	1.1	1.2	1.4	1.7	2.1	2.5
10-year Treasury Note	3.9	3.7	3.8	4.0	4.2	4.4	4.7	4.8

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Persisting Sluggish Labor Markets?

Despite the outlook for an improving economy, the sluggish performance of the labor market has remained a frustrating part of the recent economic situation. With ongoing high rates of productivity growth (increases in output per hour of labor), businesses have been increasing output while holding down costs, including labor costs. Productivity growth has continued at elevated levels, sustaining the higher rate of trend productivity growth of about 2½ percent in recent years, compared to the 1½-percent trend rate of growth that occurred over the 1973-95 period (see chart below). In the long run, higher trend productivity growth is beneficial in terms of higher growth of real wages and higher standards of living; in the short run, however – and with a slow-growing economy – the higher productivity growth can result in sluggish labor markets. A rebound in confidence is needed for businesses to anticipate the return to sustained growing demand for their products and the need for additional labor.

Unemployment insurance claims rose sharply during and immediately following the Iraq conflict; and despite an initial decline from their elevated levels, they have stayed stubbornly high recently – above the 400,000 level typically associated with a neutral labor market. In May, the unemployment rate rose to 6.1 percent – the high for this cycle – and payroll employment fell by 17,000 jobs.

Even an improving economy might not immediately push down the rate of unemployment. Instead, it could attract greater labor force participation – the percentage of the

population that is working or actively seeking employment – which had declined in the past 2 years. A rise in participation just as the outlook improves could keep the unemployment rate higher even as job growth initially picks up – until sustained stronger job growth resumes and more workers who want jobs can find them.

Despite these concerns, the recent employment data suggest that the labor market is stabilizing and no longer declining sharply as occurred during the recession. The questions that remain, though, are: 1) How soon will labor markets improve? and 2) How strong will the improvement be? The Blue Chip forecast cited above indicates that the labor market will start to show signs of improvement later this year, with more significant gains occurring through 2004. The recently enacted tax relief bolsters the likelihood of significant labor market improvement.

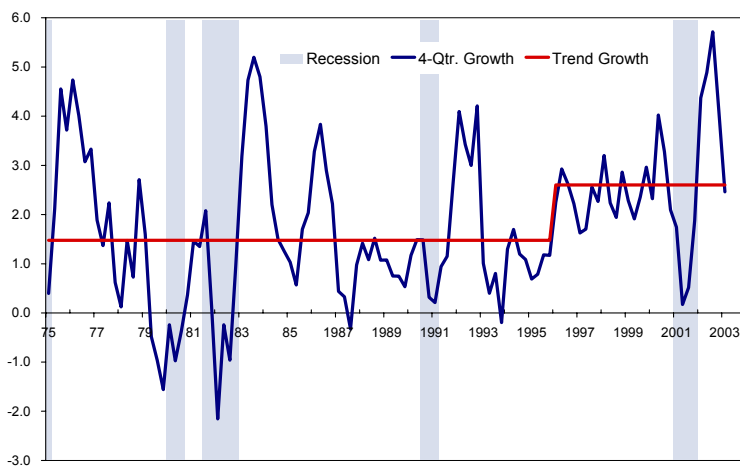
Tax Reduction, Potential Interest Rate Cut

The new tax legislation – the Jobs and Growth Tax Relief Reconciliation Act of 2003 – will result in immediate tax relief, with 25 million families receiving checks totaling \$14 billion in advance payments for the increased child tax credit in July, according to the Department of the Treasury. In addition, workers will have higher take-home pay, as companies adjust income tax withholding to account for the measure's rate reductions. Businesses will realize substantial immediate tax reductions associated with the increased expensing and accelerated depreciation of investment spending. All told, the tax plan amounts to more than \$200 billion of tax relief and State aid over the next 16 months, equivalent to 2 percent of GDP.

Even Fed Chairman Alan Greenspan, who in February questioned the desirability of additional economic stimulus, on 3 June said: "Fortuitously, this particular tax cut is happening at the right time." Chairman Greenspan and the Fed have recently acknowledged concern about the economy's performance and "the probability of an unwelcome substantial fall in inflation." Financial markets anticipate the Fed may be ready to lower interest rates further to promote economic activity and provide "insurance" against possible "deflation" – that is, sustained declines in prices.

All told, these aggressive policy actions – both fiscal and monetary – are intended to help assure the economy returns to stronger expansion with an improving labor market and job growth.

PRODUCTIVITY GROWTH -- NONFARM BUSINESS SECTOR



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